POLICY BRIEF: 04M-09/24

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UNRAVELLING INFLATION: THE ROLE OF MONETARY POLICY, KEY DRIVERS, AND CONTRIBUTIONS

POLICY MEASURES FOR MITIGATING INFLATION

Gradually reduce interest rates while monitoring inflation

The SBP should consider lowering the policy rate from 19.5% to 15% gradually with an initial reduction of 250 bps in the MPC meeting due in Sep 2024. Despite a 3-4% rise in inflation from budget measures, the real interest rate would still stay positive. Notably, a 1% rate cut could save around Rs. 467 bn in debt servicing.[1]

Develop Alternative Inflation Indices

Authorities should create distinct indices for demand-pull and cost-push inflation so that the nature of inflation can be better predicted and relevant policy tools be adopted. Currently, demand-suppressing tools like policy rate adjustments are often misapplied to counter cost-push inflation.

Enhance Demand Management Through Targeted Regulations

The SBP should employ tools beyond interest rates, such as adjusting liquidity requirements like the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) to curtail demand-induced inflationary pressure.

Targeted Inflation Control with Global Insights

Strengthen the CCP's role in curbing anti-competitive practices in key sectors, while following Turkiye's example by investing privatization proceeds in renewable energy. Adopt climate-adaptive strategies to reduce reliance on imports and enhance supply chain efficiency, mitigating supply-side inflation.

Coordination between Monetary and Fiscal Policy

Policy rate hikes to curb inflation have raised debt servicing costs, driving up taxes and tariffs, which further fuel inflation. To avoid such counterproductive outcomes, SBP must closely coordinate with the Ministry of Finance when setting monetary policy, ensuring alignment with broader economic objectives.

Stabilize Currency and Forex Reserves

Introduce a currency peg with adjustable bands, monitored through the REER index, to stabilize the exchange rate. Additionally, implement Cash Margin Requirements (CMR) for importers and limit excessive credit card spending to conserve forex reserves and mitigate speculative currency outflows.

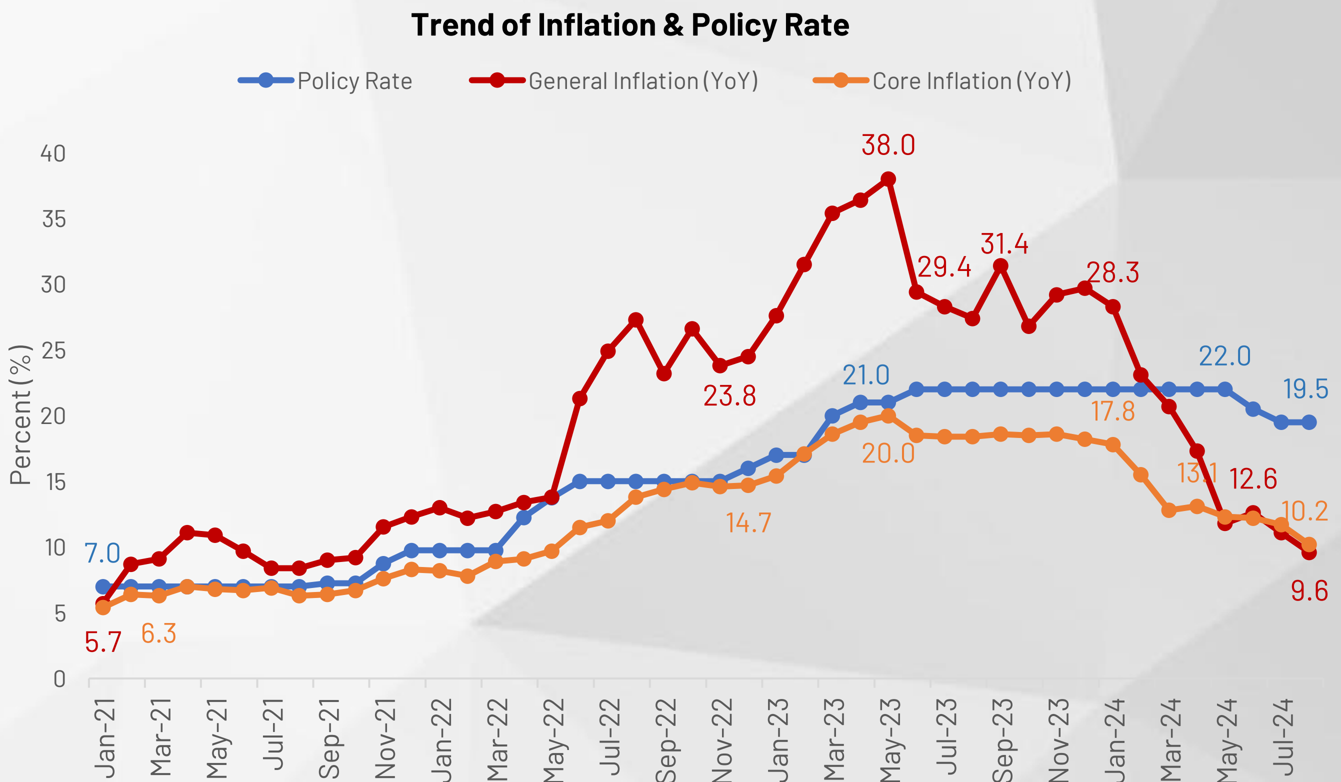
[1] https://tribune.com.pk/story/2470873/policy-rate-set-at-205-after-1st-cut-in-nearly-4-yearsa

1. Inflation Trends in Pakistan

Inflation has been a persistent challenge for Pakistan in recent years, gradually increasing since 2021 and reaching 21.3% in June 2022. However, inflation surged sharply between November 2022 and May 2023, peaking at 38.0% in May 2023. After this peak, inflationary pressures began to ease, with prices steadily declining to 9.6% by August 2024. Core inflation followed a similar trajectory, rising from 5.4% in January 2021 to a high of 20.0% in May 2023 before decreasing to 10.2% in August 2024. Despite these improvements, inflation has remained in double digits for 33 consecutive months during November 2021 to July 2024.

In response to rising price levels, the State Bank of Pakistan (SBP) steadily increased the policy rate from 7% in August 2021 to 21% in April 2023. The unprecedented 38% inflation rate prompted the SBP to further raise the benchmark rate to a record-high 22%, amidst domestic uncertainty and external vulnerabilities. Over this period, the policy rate was raised by 1500 basis points to address inflationary pressures, before being reduced to 20.5% in June 2024 and then to 19.5% in July 2024, following a drop in inflation.
The data reveals that despite consistent hikes in the policy rate, inflation continued to rise until it began to decline in June 2023. This trend raises questions about the effectiveness of the SBP's conventional monetary policy tools and underscores the need to explore the underlying factors contributing to the recent decline in inflation.

Figure 1: Inflation & Policy Rate Trend

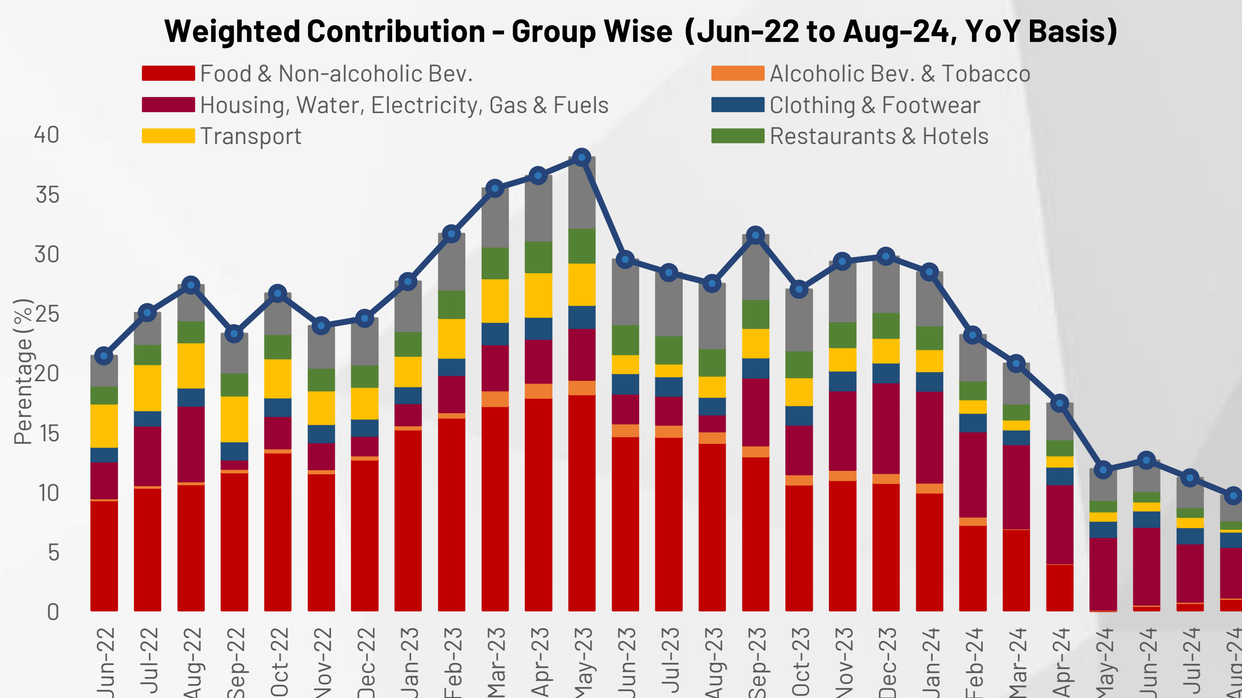


Source: Pakistan Bureau of Statistics (PBS) and State Bank of Pakistan (SBP)

1.1. Contribution and Group-Wise Breakup of Inflation

The graph below illustrates inflation trends over the past two years, highlighting the contributions of various sectors to the overall inflation rate. It underscores the dominance of the food sector and energy costs on inflation. Leading up to May 2023, rising prices in the food, beverages, and housing & utilities sectors significantly drove up inflation. The food sector, in particular, remained the largest single contributor to inflation, even during periods of decline, underscoring its substantial impact on the overall rate. The energy sector also played a critical role in sustaining inflationary pressures and remained a key contributor through the latter half of FY24.

Figure 2: Weighted Contribution in Inflation (Percentage Points), YoY in Pakistan - (Jun 2022-Aug 2024)

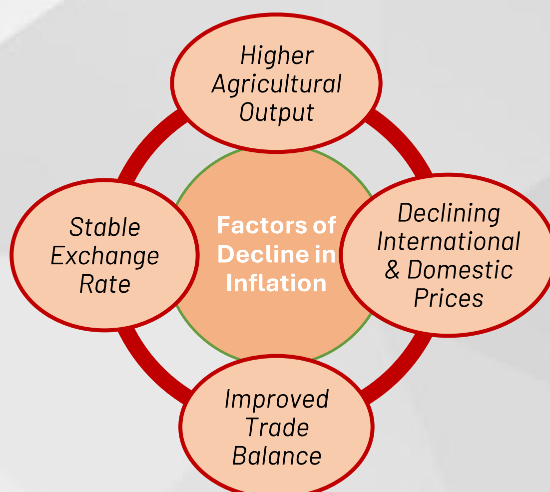


Source: Pakistan Bureau of Statistics (PBS) and Authors' estimates
*Note: The weighted contribution is calculated in percentage points. It is calculated using Ith = [Iith1- Iith0 / Ioverall0]*wi × 100*

2. Key Drivers of Recent Decline

The recent wave of price reductions can be attributed to a combination of supply-side adjustments and strategic administrative measures. A thorough analysis of these factors in subsequent sections will offer a deeper understanding of the underlying dynamics shaping the current inflation trends.

Figure 3: Drivers of Decline in Inflation

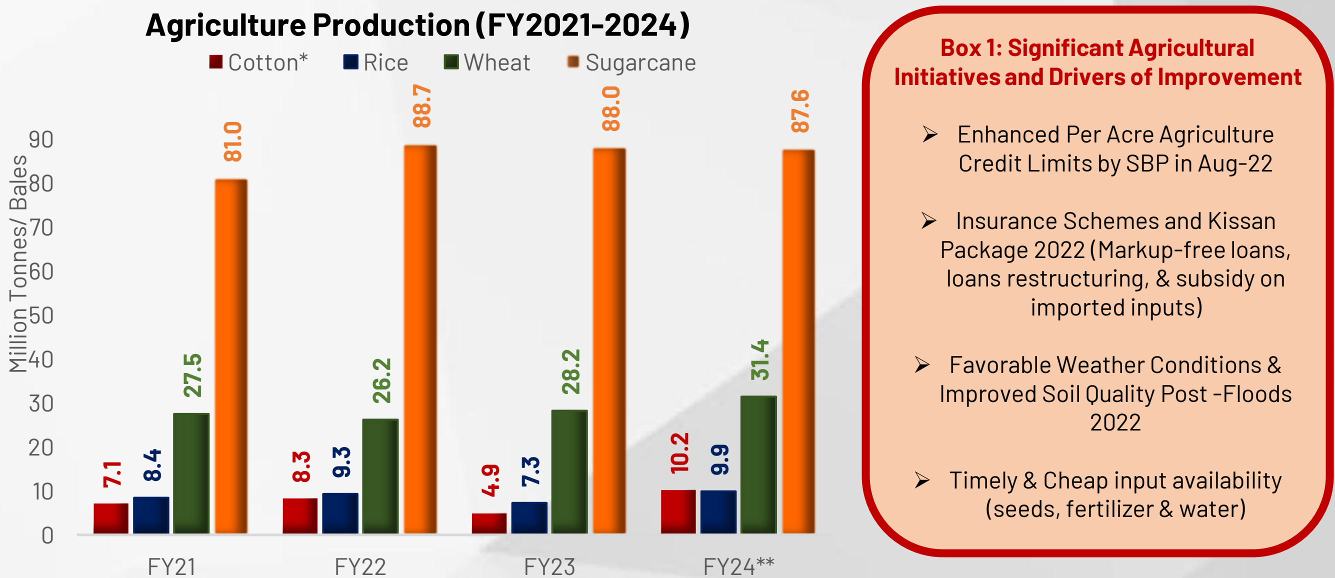


2.1. Higher Agricultural Output

Food has been the primary driver of inflation in FY23, culminating in a staggering peak of 48.1% in May 2023, up from 15.5% in May 2022. This surge in food inflation was exacerbated by unprecedented torrential rains and devastating floods in July and August 2022. The agricultural sector bore the brunt of this natural disaster, with approximately 82% of total flood damages concentrated on crops, affecting 4.4 million acres. Nearly one-third of the nation was submerged, with kharif crops such as cotton and rice suffering significant losses, registering production declines of 41.0% and 21.5%, respectively, in FY23 compared to the previous year. These disruptions contributed to the sharp rise in domestic commodity prices during the same period.

In response to this agricultural crisis, the government implemented comprehensive stimulus packages, including relaxed agricultural credit limits and subsidized loans aimed at revitalizing the sector. Agricultural credit disbursements increased by 34.5% this year, reaching Rs. 1.79 trillion in FY24, up from Rs. 1.33 trillion in FY23. Combined with other supportive measures (see Box 1), these initiatives yielded impressive results, driving overall sectoral growth to 6.25% in FY24, including a remarkable 11.03% expansion in crop production—an unprecedented growth after a decade. Wheat output surged by 11.3%, surpassing its annual target of 30 million tons, while cotton production experienced a phenomenal 108.2% increase due to expanded cultivation. This resurgence in agricultural productivity is directly reflected in the moderation of food inflation, which fell to 2.6% in June 2024.

Figure 4: Production of Major Crops in Pakistan & Reasons for Enhanced Production

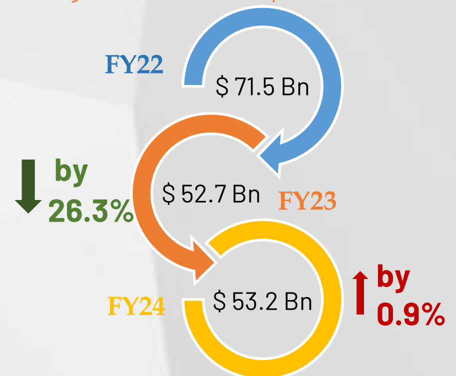


Source: Pakistan Economic Survey
**Cotton production is in Million Bales, while the other production figures are in Million Tonnes.*
***FY24 Figures are for the period of July-Mar only*

2.2. Improved Trade Deficit through Policy Interventions

In FY22, the current account balance recorded a significant deficit of US$ 17.5 billion, but it improved markedly to US$ 0.7 billion by FY24. Despite low inflows and increased debt servicing costs due to higher policy rates, the trade deficit played a crucial role in narrowing the current account deficit. To mitigate external vulnerabilities, the government imposed a temporary import ban on over 500 products in May 2022. This led to an immediate drop in imports, which fell from US$ 7.2 billion in June 2022 to US$ 5.6 billion in July 2022, ultimately bringing total imports down to US$ 52.7 billion by the end of FY23.

Figure 5: Decline in Imports



Source: State Bank of Pakistan, SBP

However, the lifting of import and trade restrictions in June 2023 introduced a degree of volatility in import levels. Despite this, imports remained relatively low during FY24, primarily due to declining international commodity prices and issues with letters of credit (LCs). Simultaneously, exports grew by 11.6% in FY24, driven by a strong agricultural performance. As a result, the trade deficit and current account deficit narrowed by 11.1% and 79.7%, respectively, during FY24 compared to the previous year.

Figure 6: Trade Statistics (Jan-22 to Jun-24)

TRADE STATISTICS

SBP bans 500+ nonessential import items & SBP approval needed for payments of 25 high-value capital goods

177 import items require 100% cash margin

Updated rules for consumer financing regulations

Withdrawal of restrictions by SBP

Increased RD on various items

HS Codes under Ch 84 & 85 added to prior approval list

Amount in Billion US$

8, 6, 4, 2, 0, -2, -4, -6, -8

Jan-22, Feb-22, Mar-22, Apr-22, May-22, Jun-22, Jul-22, Aug-22, Sep-22, Oct-22, Nov-22, Dec-22, Jan-23, Feb-23, Mar-23, Apr-23, May-23, Jun-23, Jul-23, Aug-23, Sep-23, Oct-23, Nov-23, Dec-23, Jan-24, Feb-24, Mar-24, Apr-24, May-24, Jun-24

Exports (Goods) | Imports (Goods) | Current Account Balance | Trade Balance (Goods)

Source: State Bank of Pakistan (SBP)

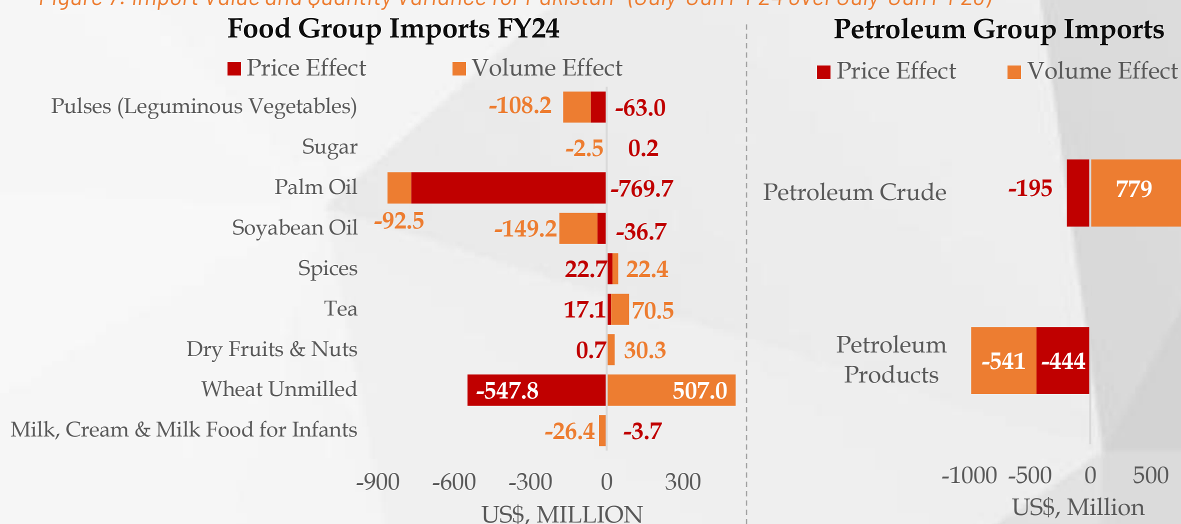
Source: State Bank of Pakistan (SBP)

2.3. Downtrend in International & Domestic Prices

Countries like Pakistan are highly sensitive to global commodity prices. As of 2023, Pakistan remains a net importer of food and energy, which significantly contributes to imported inflation. This reliance on imports has grown due to shortfalls in domestic production. In FY24, Pakistan experienced a notable decline in the value of imports across most categories, particularly in the 'Food Group' (11.6%) and the 'Petroleum Group' (0.6%). This decline was largely driven by a significant drop in global commodity prices and improved domestic agricultural production.

The impact of price changes was more pronounced than changes in import volumes (see Figure 7). Within the food group, the total value of imports decreased by approximately US$ 1,380 million due to falling prices despite an increase of US$251 million driven by higher import volumes, resulting in a net decline of US$1,129 million. Similarly, in the petroleum sector, the total reduction in the import bill for crude and petroleum products was US$ 401 million (-0.6%), with US$ -639 million attributed to lower prices, while the increase in volume added only US$ 238 million to the total import bill.

Figure 7: Import Value and Quantity Variance for Pakistan- (July-Jun FY'24 over July-Jun FY'23)



Source: Pakistan Bureau of Statistics & Authors' Estimates

Global commodity prices started to decline in the latter half of 2022, but the domestic market did not fully benefit from this due to factors like currency depreciation and high fuel prices. For instance, despite a 25% drop in global wheat prices by mid-2023, domestic wheat prices remained high between January 2022 and December 2023. This was due to climate-related issues, higher Minimum Support Prices (MSP) for wheat, and artificial shortages.

Table 1: Trend in Global Prices of Major Commodities

Commodity	Unit	International Prices of Major Commodities				% Change		
		Jun 2021	Jun 2022	Jun 2023	Jun 2024	Jun 2021 -22	Jun 2022-23	Jun 2023 -24
Crude Oil	$/bbl	71.8	116.8	73.3	81.2	62.7	-37.3	10.8
Wheat	$/MT	285.6	459.6	345.5	265.6	60.9	-24.8	-23.1
Palm Oil	$/MT	1004.4	1501.1	817.0	873.7	49.4	-45.6	6.9
DAP	$/MT	604.8	783.8	454.6	543.0	29.6	-42.0	19.5

Source: Commodity Prices Pink Sheet, World Bank

The government's strategy to import wheat during a period of declining global prices, coupled with provincial measures to combat hoarding and smuggling, led to reduced prices for wheat and other key commodities like sugar and urea after the first quarter of FY24. Despite the global drop in fuel prices, domestic prices did not follow suit, as illustrated in Table 2. Fuel prices in the domestic market rose from Rs. 179.9 per liter in June 2022 to a peak of Rs. 331 per liter in September 2023, before decreasing to Rs. 258.2 per liter by June 2024. This surge was mainly driven by a steady increase in the petroleum development levy, which surged from an average of Rs. 7.5 per liter in June 2022 to Rs. 50 per liter in June 2023 to meet revenue targets.[2] While the decline in fuel and other commodity prices offered some economic relief, electricity tariffs, and gas charges remained elevated to satisfy IMF requirements.

Table 2: Trend in Domestic Prices of Major Commodities

Commodity	Unit	Domestic Prices of Major Commodities				% Change		
		Jun 2021	Jun 2022	Jun 2023	Jun 2024	Jun 2021-22	Jun 2022-23	Jun 2023-24
Petrol	PKR/Litre	108.6	179.9	262.0	258.2	65.7	45.7	-1.5
Electricity Tariff	Per Unit	6.0	5.8	6.2	7.3	-3.7	6.8	19.0
Gas Charges	MMBTU	141.6	141.6	295.0	1976.5	0.0	108.4	570.0
Wheat Prices	20 Kg	1135.9	1218.1	2535.9	1773.1	7.2	108.2	-30.1

Source: OGRA and Pakistan Bureau of Statistics (PBS)
Note: Electricity tariff is considered for up to 50 units, and Gas charges are considered for up to 3.3719 MMBTU.

2.4. Stable Exchange Rate Amid FOREX Constraints

A stable exchange rate is pivotal in controlling inflation, as it helps reduce the volatility in import costs, directly impacting the prices of goods and services within a country. However, during the period under review, Pakistan's exchange rate was anything but stable, experiencing significant fluctuations due to dwindling foreign exchange reserves, external pressures, and market uncertainties. The exchange rate peaked at 306 PKR/USD in August 2023, contributing to heightened inflationary pressures as the cost of imported goods soared.

To address this instability, the State Bank of Pakistan (SBP) implemented several measures aimed at curbing exchange rate volatility. These included an import ban on non-essential items, forex constraints such as an annual limit of $30,000 per person on card transactions, stricter guidelines for permissible foreign currency transactions by Exchange Companies, and the suspension of authorization for B-category Exchange Companies (ECs).

[2] State Bank of Pakistan (SBP)

Figure 8: Exchange Rate and Volatile Foreign Exchange Reserves

EXCHANGE RATE PARITY AND FOREX RESERVES

Total Liquid Forex Reserves (RHS) | Exchange Rate (M2M Rate) | Open Market Rate

Import ban on 500+ items. Prior approval on import of 25 high-value capital goods.

Per year limit of $30k/ person on card transactions

Import guidelines for US$ & ECs allowed to export permissible FCs.

Crackdown on Illegal & Hoarding Activities of FCs. Min. paid-up capital requirement of PKR 200 Mn for ECs.

Suspended authorization for B-category ECs.

312 318 285 306

PKR/US$: 0 50 100 150 200 250 300 350 400

Total Liquid Reserves (Billion US$): 0 5 10 15 20 25

Jan-22 Feb-22 Mar-22 Apr-22 May-22 Jun-22 Jul-22 Aug-22 Sep-22 Oct-22 Nov-22 Dec-22 Jan-23 Feb-23 Mar-23 Apr-23 May-23 Jun-23 Jul-23 Aug-23 Sep-23 Oct-23 Nov-23 Dec-23 Jan-24 Feb-24 Mar-24 Apr-24 May-24 Jun-24

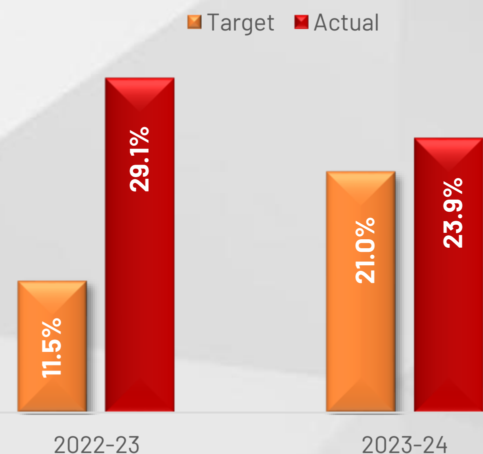
Source: State Bank of Pakistan (SBP)

3. Monetary Policy Response and Inflation Outlook by MPC-SBP

Table 3 assesses the Monetary Policy Committee's (MPC) inflation outlook over the past two years. In response to varying inflation, the MPC regularly changed interest rates from July 2022 to June 2023. Inflation targets were revised multiple times, including adjustments to both fiscal year and medium-term projections. The accuracy of the Monetary Policy Committee's (MPC) forecasts also varied, often underestimating inflation levels.

Similarly, during the price downturn, the MPC correctly anticipated a drop in inflation; however, they underestimated its severity, which was greater than expected due to falling food and fuel prices. Additionally, the MPC acknowledged in their meetings and statements that inflationary pressures eased

Figure 9: Budgetary Inflation Target vs Actual Inflation



Source: Ministry of Finance & Pakistan Bureau of Statistics (PBS)

due to lower administered prices (fuel) and supply constraints (import and forex restrictions). Despite this, the MPC continued to rely on demand management tools to curb price increases. Figure 9 shows that average inflation in the last two fiscal years (FY23 and FY24) exceeded the targets set during the budget.

Table 3: Pakistan's Inflation Outlook by MPC (Jul-2022 to Jun-2024)

Date	MPC Decision	MPC's Inflation Forecast	Comments
7-Jul-22	↑125 bps to 15%	Remain elevated at existing levels. FY23 Avg: 18-20%	Inflation remained volatile, exceeding MPC's expectations. FY23 Avg: 29.05%
22-Aug-22	→ at 15%	Peak in Q1 FY23 & then fall	Inflation dropped in Q1 FY23, contrary to the MPC's expected increase
10-Oct-22	→ at 15%	Gradual decline in H2-FY23	Inflation kept rising through most of the H2-FY23, peaking at 38% in May-23
25-Nov-22	↑100 bps to 16%	FY23 Avg. Inflation revised to 21-23%	Jul-Oct 22 average inflation of 25.5% exceeded MPC's annual projection.
23-Jan-23	↑100 bps to 17%	Upside risks due to administered prices. Fall to 5-7%by Dec-24	Continued rising trend, however, FY25 budget measures may not keep inflation within 5-7% by Dec 24
2-Mar-23	↑300 bps to 20%	FY23 Avg. Inflation revised to 27-29%	After two revisions, FY23 Avg inflation was 29.05%, finally within the MPC's range
4-Apr-23	↑300 bps to 21%	-	-
12-Jun-23	→ at 21%	Expected to decline from Jun-23.	Declined during 2 months but started increasing and reached to 31.4% in Sep-23
26-Jun-23	↑100 bps to 22%	Revised Medium-term target: 5-7% by FY25	-
31-Jul-23	→ at 22%	Avg. FY24: 20-22%, Below 20% in H2FY24	FY24 Avg remained at 23.9% significantly higher than MPC's initial projected range
14-Sep-23	→ at 22%	Expects Hike in Sep-23 & fall in Oct-23	Inflation was in line with the outlook
30-Oct & 12-Dec 2023	→ at 22%	Significant Drop in H2 FY24	As expected by MPC, inflation followed a downward trajectory since Jan -24
29-Jan-24	→ at 22%	Avg. in FY24: 23-25%	FY24 Avg inflation was 23.9%, within the MPC's range
18-Mar-24	→ at 22%	Possible Hike subject to administered prices	Inflation dropped from 20.7% in Mar-24 to 17.3% in Apr-24, unanticipated by MPC
29-Apr-24	→ at 22%	Inflation to follow downward trajectory	Inflation declined in line with MPC's projections
10-Jun-24	↓ 150 bps to 19.5%	High inflation risk in Jul-24, then decline in FY25	Fell to 11.1% in Jul-24 from 12.6%(Jun-24), contrary to the MPC's expected rise

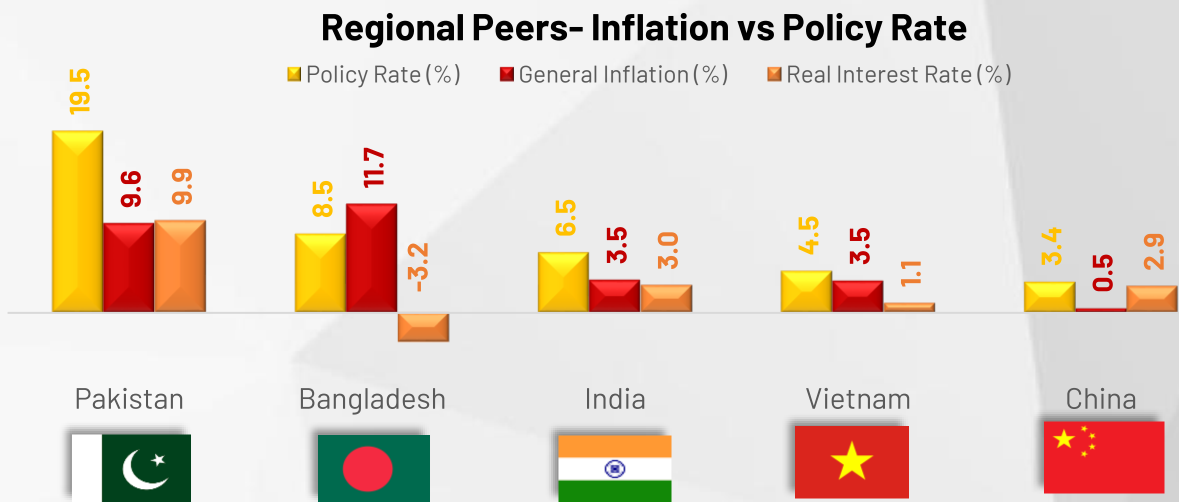
Key for MPC Decision: ↑ indicates increase, ↓ indicates decrease, → indicates status quo

Q1 = 1st Quarter, H1 = First Half, H2 = Second Half

4. Regional Comparison: Inflation Vs Interest Rates

Despite two consecutive policy rate cuts by the MPC, Pakistan's current benchmark rate of 19.50% remains significantly higher than those of regional peers, including India (6.5%), Bangladesh (8.5%), China (3.4%), and Vietnam (4.5%). Additionally, Pakistan has the highest real interest rate in the region, highlighting the elevated borrowing costs compared to its neighbors. This high policy rate has significantly contributed to Pakistan's growing debt burden. According to the Ministry of Finance, markup payments on domestic borrowing increased by 50.4% in FY24 compared to FY23, driven by the sustained high policy rate, which has further strained the country's fiscal capacity.

Figure 10: Comparison with other Regional Countries- Inflation and Policy Rate



Source: SBP, PBS, and Respective Central Banks & Statistical Bureaus

Note: Inflation figures for Pakistan & Vietnam are of August 2024, while figures for other countries are of July 2024

5. Budgetary Measures under FY2024-25 and Inflationary Pressure

Pakistan's tax reliance is heavily skewed towards indirect taxes. According to the Federal Board of Revenue (FBR), in FY2022-23, approximately 54.3% of the country's tax revenue came from indirect taxes, while only 45.7% was derived from direct taxes. Continuing this trend, the Budget for 2024-25 introduces additional tax measures that further push indirect tax levers. These regressive taxes significantly contribute to inflationary pressures. The measures introduced in the Federal Budget 2024-25, including higher Sales Tax, Duties, and increased Petroleum Development Levies, are expected to further drive inflation by an additional 3-4%, as illustrated in Table 4.

Table 4: Impact of Key Budgetary Measures 2024-25 on Inflation

Heads	Weight	Weighted Inflation	Heads	Weight	Weighted Inflation
Petroleum Development Levy	0.5064	0.04	**Customs Duties**		
Sales Tax Amendments			High speed diesel oil	0.5	-0.046
Infant Preparations & Fat filled milk	0.31	0.06	Natural gas	1.1	-0.051
Packaged Milk	0.64	0.12	Containers for aerosol products	1.4	0.226
Stationery Items	0.35	0.03	Other parts of Submersible pumps	0.0	-0.0002
Edible vegetables imported from Afghanistan	1.53	0.28	Electrical Appliances	0.0	0.000
Fruit imported from Afghanistan excl. apples	1.44	0.26	Other Appliances	3.0	-0.332
Diagnostic kits or equipment	0.01	0.001	Drugs and medicines	1.1	-0.106
Oil cake & other solid residues	2.04	0.20	Fresh and Dry Fruits excl. apples from Afghanistan	1.4	0.161
Tractor	0.81	0.08	Wheat	0.6	0.067
Machinery and equipment	0.65	0.12	Sugar	1.1	0.340
Bakery Items (Tier - I)	0.48	0.05	**Federal Excise Duty**		
Poultry Feed	1.36	0.14	Cement	0.4	0.010
Iron and steel scrap	0.38	-0.07	Air Tickets	1.7	0.140
LPG Imports	1.08	0.08	Lubricating Oil	0.2	0.010
Textile & Leather	0.84	0.02	Cigarettes	0.7	0.340
PCs and Laptops	0.05	0.002	Residential Plot	19.3	0.578
Cellular Phones	0.45	0.08	Sugar	1.1	0.056
Total Expected Inflation: 3-4%					

Note: The calculation is based on prices used from the PBS utilizing urban CPI weights
The calculation includes only items with available price data, excluding those for which prices could not be found.
Source: Authors Estimates

6. Conclusion

Pakistan's current inflation situation demands a comprehensive approach that balances immediate actions with long-term structural reforms. Instead of policy rate, a combination of supply and administrative measures has been instrumental in reducing inflation during the last year. Gradually easing the policy rates is imperative, alongside measures to stabilize the currency, diversify energy sources, streamline supply chains, and exercise fiscal prudence. By adopting a multifaceted strategy, policymakers can effectively tackle inflationary pressures, ensuring sustained economic stability and fostering growth in Pakistan. Key findings are as follows:

1. **Persistent Inflationary Trend:** Inflation in Pakistan saw a significant rise starting from 2021, peaking at 38.0% in May 2023 before gradually declining to 9.6% by August 2024. Despite this decline, inflation remained in double digits for 33 consecutive months

November 2021-July 2024.

2. **Effectiveness of Monetary Policy:** The consistent hikes in the policy rate, which peaked at 22% in June 2023, largely remained ineffective in curbing inflation. However, the decline in inflation from June 2023 onwards suggests that other factors, such as supply-side adjustments, played a more significant role in reducing inflationary pressures.
3. **Dominance of the Food and Energy Sectors:** The food and energy sectors were the primary drivers of inflation, contributing significantly to the overall inflation rate even during periods of decline. The sharp rise in food prices was exacerbated by natural disasters, such as floods, which severely impacted agricultural production.
4. **Impact of Supply-Side Measures:** The decline in inflation from mid-2023 was largely attributed to government interventions in the agricultural sector, including stimulus packages, increased agricultural credit, and improved weather conditions. These measures led to a resurgence in agricultural productivity, particularly in crop production.
5. **Budgetary Pressures and Indirect Taxation:** The heavy reliance on indirect taxes in the 2024-25 budget, including increases in sales tax and duties, is expected to further drive inflation by an additional 3-4%. This reliance on regressive taxes contributes significantly to the inflationary pressures faced by the economy.
6. **Challenges in Fiscal Management:** The high policy rate and the resulting increase in debt servicing costs have strained the country's fiscal capacity. Markup payments on domestic borrowing increased by 50.4% in FY24 compared to FY23, further exacerbating fiscal challenges.

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